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No. 85-1035

In The

Supreme Court of the United States

October Term, 1985

CROCKER NATIONAL BANK,

Appellant,

v.

PAUL PERDUE,

Appellee.

On Appeal from the Supreme Court
of the State of California

BRIEF OF
AMICI CURIAE MIDLANTIC BANKS INC.,
FIRST FIDELITY BANCORPORATION,
HORIZON BANCORP, AND
PHILLIPSBURG NATIONAL BANK

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INTEREST OF THE AMICI CURIAE

This *amicus curiae* brief is filed on behalf of a number of New Jersey banks and bank holding companies (hereinafter referred to collectively as "New Jersey *amici*") in support of the Jurisdictional Statement filed by appellant Crocker National Bank ("Crocker").[1] Each

[1] The institutions on behalf of which this brief is filed are Midlantic Banks Inc., First Fidelity Bancorporation, Horizon Bancorp and Phillipsburg National Bank.

New Jersey *amicus* operates one or more nationally chartered banks that accept deposits from the general public in accordance with and subject to the rules and regulations of the Comptroller of the Currency (the "Comptroller"). These deposits are insured pursuant to the provisions of the federal deposit insurance program.

The decision below purports to set aside a regulation of the Comptroller that directs national banks generally to establish service fees in accordance with competitive market conditions. Specifically, the California court struck down this regulation to the extent that it would permit a national bank to price service fees at a level determined by subsequent state judicial scrutiny to be in excess of "cost" plus a "reasonable" profit. New Jersey *amici* are potentially directly affected by this decision. The banks operated by New Jersey *amici* levy service charges of the same type as those charged by Crocker and challenged by the plaintiff in this case. Moreover, the holding below is especially likely to affect New Jersey *amici* because it rests on a general theory of "unconscionability" that could be adopted in New Jersey absent a finding of federal preemption.[2] If this were to happen, service fees

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[2] The statute relied upon by the California court, Cal. Civ. Code 1670.5, tracks the language of the basic unconscionability provision of the Uniform Commercial Code, enacted in New Jersey as N.J. Stat. Ann. 12A:2-302 (1962). As noted by Crocker, Jurisdictional Statement at 6, the decision below is the first known example where a price not in excess of the fair market price was nonetheless held to be potentially unconscionable. *Cf. Toker v. Westerman*, 113 N.J. Super. 452, 274 A.2d 78 (Dist. Ct. 1971) (price equal to 2-1/2 times reasonable market value held to be unconscionable).

charged by New Jersey *amici* in accordance with competitive conditions and the Comptroller's regulations could nevertheless be reduced and refunded as a result of state court proceedings.

If the decision below is not reversed, New Jersey *amici* will be faced with an untenable dilemma. On the one hand, if they continue to comply with the regulations and directives of the Comptroller, they run the risk that New Jersey courts will adopt this newly announced application of what the California court characterized as a consequence of the principle of unconscionability and might impose retroactive refund liability for service fees that are determined to be competitive but are nevertheless, in a court's judgment, "excessive". On the other hand, if New Jersey *amici* do reduce their service fees, this would reduce a significant source of revenue. In that event, New Jersey *amici* would then have to choose between accepting lowered levels of income or reducing the rates they pay on deposits. The former choice has serious implications for the safety and soundness of banking institutions, and the latter may lead to an erosion of the deposit base in favor of financial institutions in other jurisdictions or the rapidly growing variety of non-bank savings vehicles, including not only the money market mutual funds that have become a formidable factor but numerous other recent entrants into the financial services market. No matter which choice the banks make, their ability to compete effectively in a deregulated financial services environment will be severely undercut. Worse yet, banks that try to predict what level of charges will pass subsequent state judicial muster will still face the specter of contingent liability while they abide a conclusive judicial deter-

mination that may be many years in the making. None of these alternatives is consistent with the strong federal policy, particularly applicable in the case of federally chartered and insured national banks, to maintain the health and stability, *i.e.*, the safety and soundness, of the nation's banking system.

SUMMARY OF ARGUMENT

Prior to 1980, both state and federally chartered depository institutions throughout the United States, including New Jersey *amici*, were severely restricted by law in the amount of interest they could pay on their federally insured deposits. As a result, these institutions competed for deposits on the basis of various non-price considerations, including the rendering of services at little or no charge.

Since 1980, however, interest rates have been deregulated, and competition for deposits has centered on institutions' willingness and ability to pay market rates of interest. In accordance with Congressional expectations, banks have unbundled their services and priced each according to market conditions. This has been particularly true in the case of national banks, such as those of the New Jersey *amici*, which have been urged by directives of the Comptroller to become increasingly active participants in the developing deregulated marketplace for financial services. See, *e.g.*, 50 Fed. Reg. 32003 (1985) (repealing limits on free checking accounts in order to permit newly established banks to compete more effectively).

If permitted to stand, the decision below will upset the Congressionally mandated preference for market forces. The reasoning of the California court would per-

mit state judiciaries to regulate important sources of bank revenue to sub-competitive levels. Depository institutions will likely be faced with a multiplicity of rules stemming from the disparate decisions of the various jurisdictions in our federal system, with the potential for contradictory variety exceeded only by the consequential dislocations in the nation's banking system. The ability of a court to impair a bank's ability to pay market rates of interest on deposit accounts (by forcing the reduction of service fee income) would be a direct and unprecedented interference with the bank's ability to attract those deposit accounts. While such a judicial assertion of power may be viewed with concern generally, it is particularly inappropriate in the case of federally chartered national banks, whose powers to attract deposit accounts are statutorily protected.

In addition, the decision below poses a very real and unprecedented risk that millions of dollars in refund liability will be imposed on banking institutions for fees that were competitive when charged but nevertheless are subsequently held to be "unconscionable". The manifest threat to the safety and soundness of the nation's banks from this combination of anti-competitive regulation and threat of retroactive refunds is a critical concern, not only because of the importance of the banking system to the nation's economic well-being, but also because, in extreme cases, of the potential claims on the Federal Deposit Insurance Corporation caused by the erosion to the profitability of banking institutions.

Finally, this Court should not uphold the intrusion of this state court holding into the still evolving market

place for financial services. Plaintiff has not directly challenged the authority of the Comptroller of the Currency to regulate national banks. Rather, the court below entertained, in the guise of consumer protection, a collateral attack on that authority as well as on the Congressionally mandated deregulation of the banking system. Such an attack, if permitted to succeed, can too easily injure the developing competitive marketplace for financial services by undercutting the capacity of banks, and most particularly of national banks, to participate effectively in that market. Banks simply cannot comply with both the federal mandate to price their services competitively in accordance with market factors in a deregulated environment and the California court's newly announced application of the doctrine of unconscionability. This direct conflict compels the conclusion that federal law preempts any attempt by a state court to force bank service charges to sub-competitive levels.

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ARGUMENT

REPRICING BY STATE COURTS OF COMPETITIVELY DETERMINED BANK SERVICE FEES VIOLATES FEDERAL LAW AND IS PREEMPTED.

At issue in this case is whether individual state courts have the power to require a bank chartered by the federal government to charge service fees at less than market levels. The specific fees attacked by plaintiff are those charged when checks are written on accounts that do not contain sufficient funds, referred to by the parties as

"NSF" charges. Under the broad language of the decision below, however, the holding can be read to apply to all service fees charged by federally chartered banks. The California Supreme Court held that the doctrine of unconscionability may be used to compel substantial reductions and refunds of NSF charges (and, by implication, of other bank service fees) if they exceed "cost" plus a "reasonable" profit, even though that level is below the discernible market range for such fees. In reaching this conclusion, the California court acknowledged, but rejected as "palpably erroneous", the opposite view of the Comptroller of the Currency, who has ruled that service fees must be allowed to reach their natural market level in order to enable national banks to compete successfully for deposits in today's ever-increasingly competitive environment, and, in the case of NSF charges, to discourage the writing of NSF checks which now number in the hundreds of millions annually.

A. Background.

For nearly 50 years prior to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (the "1980 Act"), codified at 12 U.S.C. 3501-3505, the ability of depository institutions, including New Jersey *amici*, to attract deposits by the payment of interest was strictly regulated, most notably by Regulation Q and related provisions promulgated by the Federal Reserve Board. 12 C.F.R. 217.7, 329.6, 526.3 (repealed 1980). The purpose and effect of this regulation was to keep the cost of funds incurred by these institutions below the rate that otherwise would have been determined by the interplay of mar-

ket forces. Gorinson & Manishin, *Garn-St Germain: A Harbinger of Change*, 40 Wash. & Lee L. Rev. 1313, 1315, 1319 n.34 (1983) [cited hereinafter as "Gorinson"]; citing Carron, *The Plight of the Thrift Institutions* 5 (1981). As is often the case in regulated industries (such as airlines or trucking) where price competition is discouraged or limited, banking institutions were restricted to engaging in "non-price" competition by opening additional branches with extended hours, by offering "hidden" interest in the form of "free" gifts, or by offering a variety of services at little or no additional charge. Gorinson, *supra*, at 1319 n.35, 1320; S. Rep. No. 96-368, at 5 (1979).

Under contemporary economic conditions, including the growth of alternative savings vehicles (such as so-called money market mutual funds), the limits on interest rates made it increasingly difficult for depository institutions such as New Jersey *amici* to attract deposits. Responding to the growing crisis, Congress enacted the 1980 Act. This Act created the Depository Institutions Deregulation Committee, which was directed to phase out all price regulation of interest rates paid by national banks and other financial institutions.

As a result of this legislation and subsequent regulatory actions since its enactment in 1980, New Jersey *amici* have been participants in an increasingly vigorous market in which financial institutions compete for deposits primarily by offering substantial interest for accounts that previously received little or no interest. In response to this trend towards competition, New Jersey *amici* have effectuated a substantial unbundling of the services they offer to the public. In order to pay the high-

est possible rates of interest on various types of depository accounts, New Jersey *amici* have instituted or increased in accordance with market conditions charges for items that were previously either free or subject to nominal charges. Experience in the marketplace demonstrates that depositors in general are attracted more by the amount of interest they can earn than by artificially low fees, especially fees for items such as NSF items that are within the sole ability of the individual customer to control.[3]

B. The Effect of the Decision Below.

The California court's willingness to require the reduction of service charges to sub-competitive levels by means of *post-hoc* judicial rollbacks creates three serious disruptions in the federal bank regulatory scheme. The decision below undermines federal law mandating deregulation, threatens the safety and soundness of banks throughout the country, and materially interferes with the exclusive regulatory and visitorial powers of the Comptroller of the Currency.

The Comptroller considered all of these factors when he issued his interpretive regulation that confirmed the preemptive effect of the federal regulatory scheme. 12 C.F.R. 7.8000; 48 Fed. Reg. 54319 (1983), amended, 49 Fed. Reg. 28237 (1984). Notwithstanding the federal forum available for review of this regulation under the

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[3] In 1980, the NSF charges established by the various institutions now operated by New Jersey *amici* ranged between $5.00 and $10.00. The present range is between $15.00 and $21.50. Not only do these fees vary widely in general, but there is considerable variation even among the institutions owned by one New Jersey *amicus*, ranging from $15.00 at one of its subsidiaries to $18.00 at a second, $20.00 at a third and $21.50 at a fourth.

Administrative Procedure Act, 5 U.S.C. 702, federal review was not sought by any adversely affected party. Instead, the California Supreme Court was asked to disregard a duly promulgated federal regulation, an invitation that it eagerly accepted without concern for the nationwide ramifications of its action. This Court should reinstate the Comptroller's regulation in order to mend the three distinct breaches in the federal regulatory scheme created by the decision below.

1. The Decision Below Conflicts with Federal Deregulation Efforts

As noted above, the amount of interest a bank is willing and able to pay on its deposits necessarily depends in part on the amount of revenue it receives from service fees. In a deregulated, competitive market, it is inevitable that services will be unbundled, and that items which were previously handled at nominal or no charge will have to be priced competitively. As Crocker has amply demonstrated, the understanding of Congress, as subsequently confirmed by the Comptroller, was that interest rates could not be allowed to float to market levels unless service fees were deregulated as well, and that service fees would likely rise as unbundling occurred. See Jurisdictional Statement at 20.

The decision below upsets this balance and in effect directs that depositors who refrain from writing NSF checks are to subsidize those who utter such checks. If all service fees are forced to sub-competitive levels, resulting in a reduction in funds available to pay interest to depositors, the net effect will be that those depositors who handle their accounts carefully will suffer reduced

levels of income because of the lower fees received from those depositors who are inattentive or careless. The California court either implicitly assumed that such a cross-subsidy would not be inconsistent with the competitive market mandated by Congress, or worse, failed to recognize the import of its decision. In any event, the court failed to realize that such a cross-subsidy would be inherently unstable in a competitive market. Unlike a franchised public utility monopoly, which can price some services at below-market rates and others at super-competitive levels, a business in a competitive market that attempts such a marketing strategy will lose customers to competitive alternatives. If banks' service fees are kept artificially low, the interest rates they pay will be kept artificially low as well, and depositors will simply go elsewhere, including to non-bank savings vehicles, as they did prior to the repeal of Regulation Q.

The "cap" on NSF fees is inherently anti-competitive and inconsistent with the federal policy in favor of competition. As the Comptroller said in issuing preemptive regulations regarding Adjustable Rate Mortgages,

> The nation's depository system is gradually being transformed from a protected system of specialized lending institutions . . . into a highly competitive system of depository institutions that are increasingly competing side by side with nondepository financial intermediaries for deposits and lending opportunities. Moreover, individual savers have become increasingly sensitive to obtaining market rates of interest on their funds.

* * *

> [S]tate actions which, in effect, deprive national banks of one of their express powers . . . are incompatible with the comprehensive federal supervision of those institutions and their intended role under federal law.

46 Fed. Reg. 18934, 18942 (1981). The Comptroller's preemption was subsequently upheld as a reasonable exercise of his general regulatory powers. *Conference of State Bank Supervisors v. Lord,* 532 F. Supp. 694, 695-96 (D.D.C. 1982).

The California court unfortunately gave only casual regard to the numerous "express powers" of national banks referred to by the Comptroller. In particular, the court saw fit to dismiss as unimportant the vital right to accept deposits granted to national banks by federal law. Paragraph 7 of Section 24 of the National Bank Act, 12 U.S.C. 24, authorizes national banks to receive deposits "without qualification or limitation" and further bestows on these banks "all such incidental powers as shall be necessary to carry on the business of banking." *Franklin National Bank v. New York,* 347 U.S. 373, 376 (1954) (holding that Section 24 preempts state statute regulating bank advertising). At least since 1980, the ability of national banks to attract and retain deposits has depended principally on their ability to pay market rates of interest. The decision below would permit state court interference with the strong federal policies underlying the powers and protections granted to national banks that were enforced by this Court in *Franklin National Bank.*

The California court suggested that using the doctrine of unconscionability to depress NSF fees below the competitive market level would not interfere with the ability

of banks to pay interest and thereby attract deposits. This reasoning demonstrates a complete failure to recognize that state judicial action which depresses prices below market levels can be just as detrimental to competition as regulation that keeps prices artificially high. See Posner, *Economic Analysis of Law* 87 (2d ed. 1977) (using doctrine of unconscionability to force one price down below market level will simply force other prices up). Banks simply cannot comply both with the federal requirement that they pay market rates of interest and a state law requirement that they hold their NSF fees below market rates. This conflict compels the conclusion that the state law requirement must fall. *Hines v. Davidowitz*, 312 U.S. 52, 68 (1941).

The California court seemingly believed that its decision was not anti-competitive because banks could reduce their NSF charges freely. But competition requires that prices be free to move both up and down. To paraphrase this Court's holding in *Albrecht v. Herald Co.*, 390 U.S. 145, 152-53 (1968),

> [S]chemes to fix maximum prices, by substituting the perhaps erroneous judgment of a [court] for the forces of the competitive market, may severely intrude upon the ability of [banks] to compete and survive in that market. Competition, even in a single product, is not cast in a single mold. Maximum prices may be fixed too low for the [bank] . . . to furnish services and conveniences which consumers desire and for which they are willing to pay.

While *Albrecht* involved private restraints on competition, its reasoning is equally applicable here because Congress has affirmatively and clearly adopted a policy of competition in the financial services industry. Cali-

fornia courts should not be permitted to impose a restraint that would dampen competition for deposits and possibly lead to a cartelization of the market. *Cf. California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 103 (1980) (striking down California resale price maintenance scheme for wine).

2. The Decision Below Threatens Banks' Safety and Soundness

The decision below is not only anti-competitive but potentially dangerous to the financial stability of many banks that charge NSF and other service fees. If allowed to stand, the California decision will plunge all federally insured banks, including national banks, into a sea of uncertainty that will threaten the safety and soundness of the entire banking system. The millions of dollars of service fees collected by banks will be subject to *post hoc* reduction by judicial bodies.[4] This reduction would not only be imposed prospectively in the form of artificially con-

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[4] The rapid growth in interstate banking anticipated to result from this Court's decision last term in *Northeast Bancorp v. Board of Governors*, 86 L.Ed.2d 112 (No. 84-363) (1985), makes it all the more important for this Court to review the California court's decision. In the absence of preemption, national banks and bank holding companies will likely encounter a growing multitude of contradictory state requirements that will tear asunder the Congressional goal of nationwide competition. New Jersey *amici* note that several bills authorizing reciprocal interstate banking are pending in the New Jersey legislature, and that New Jersey *amici* may soon be active competitors in a number of other states. A. 3982, A. 4339, A. 4343, S. 3226, S. 3506, 201st N.J. Legislature (1984-85).

strained prices but would also lead to massive refunds that of necessity would come out of the banks' capital.[5]

Moreover, a court-enforced doctrine of unconscionability is the worst possible way to regulate NSF fees. No sort of pre-clearance is available — a bank must simply set its prices and then hope that a court will not find them to be "excessive". Nor is the court's standard of "cost" plus a "reasonable" profit one to which banks can adhere without significant risk. There are no uniform cost allocation manuals or methodologies in use in the banking industry that produce the one "right" price for NSF fees. Yet the decision below forces a bank to choose a price at its peril. If it happens to choose the "wrong" price, meaning one not in accordance with a subsequent judicial decision, it may be forced to refund the difference. The decision below is surely capable of generating in every state, including New Jersey, considerable litigation in which plaintiffs will seek to impose refund liabilites on banks.

3. The Decision Below Interferes with the Comptroller's Responsibilities

The California court further assumed that its newly announced doctrine of "unconscionability" could be applied against national banks without interfering with the exclusive supervisory and regulatory powers of the Comp-

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[5] Even though depositors are the principal beneficiary of higher service fees, since the fees enable banks to pay higher rates of interest on deposits, it would clearly be impossible to require depositors to turn over a portion of the interest they have earned as a subsidy to those who have written bad checks. Prospectively, of course, this cross-subsidy from depositors who do not write bad checks to those who do is precisely what the California decision would require.

troller. This assumption is simply not true. As explained by Crocker, Jurisdictional Statement at 14-17, the Comptroller's broad supervisory powers and its exclusive visitorial powers work together to make service fees such as NSF charges the subject of Comptroller regulation that may not be repriced as a result of state judicial proceedings. Such repricing would necessarily involve a probing scrutiny of a bank's books and records that would conflict with the Comptroller's responsibilities. 12 U.S.C. 484; 12 C.F.R. 7.6025. Even if one were to assume for the sake of argument that New Jersey substantive law prohibits banks from charging competitively determined fees that happen to be in excess of their costs — a question that is not presented and need not be reached here — enforcement of that substantive law must be left to federal regulators, who would have the power to recommend repricing on a prospective basis without necessarily ordering massive refunds that would undermine the safety and soundness of the affected institutions. See *Conference of Federal Savings and Loan Associations v. Stein*, 604 F.2d 1256, 1260 (9th Cir.), aff'd per mem., 445 U.S. 921 (1979) (California anti-redlining law must be enforced, if at all, by Federal Home Loan Bank Board); *National State Bank v. Long*, 630 F.2d 981, 988-89 (3d Cir. 1980) (New Jersey anti-redlining law cannot be enforced by State Commissioner but only by Comptroller).

Significant interference with the Comptroller's responsibilities will result from the California court's decision. For example, the effect of the California ruling will be to force NSF fees down to artificially low levels and to remove the principal deterrent against writing NSF checks. Yet the Comptroller has specifically directed the banks

under his supervision to consider the deterrent factor when they establish NSF fees. 12 C.F.R. 7.8000; 48 Fed. Reg. 54319 (1983). Thus, the decision below in effect compels banks to disregard the instruction of the Comptroller. It directly conflicts with the national goal of reducing the number of NSF checks, recently estimated at approximately 400 million each year. *American Banker*, May 15, 1984, at 2.[6]

In sum, the decision below leaves New Jersey *amici* and all other national banks in every state with irreconcilable obligations under federal and state law. Congress has determined that the market in which all depository institutions compete should be deregulated so that interest rates and related fees can float to their natural market levels. The Comptroller has directed national banks in particular to participate vigorously in the deregulated marketplace. This federal determination has been invalidated in California on reasoning that is equally applicable in New Jersey and throughout the nation. New Jersey *amici* have been and expect to continue to be vigorous competitors in the newly deregulated market, but they cannot compete if their market-determined service fees are subjected to periodic *post hoc* challenge and downward adjustment and refund by state courts. If service fees are depressed to below-market levels, either interest rates or bank earnings will be depressed as well. In either event, as explained here and in Crocker's Jurisdictional Statement, the safety and the soundness of the banking system may be put into play.

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[6] Higher NSF fees unquestionably serve as a deterrent to the writing of such checks. When Girard National Bank in Philadelphia increased its fee to $30 several years ago, the number of NSF checks processed by it was reduced by 35%. *American Banker*, May 19, 1981, at 4.

CONCLUSION

For the foregoing reasons, as well as the reasons expressed in Crocker's Jurisdictional Statement, this Court should note probable jurisdiction and reverse the decision of the California Supreme Court.

Respectfully submitted,

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